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beyond the expected

Briefing

Teachers' Pension Scheme: small steps towards certainty

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Last year we set out some of the background to the September 2019 sharp increase in the contribution rate required of employers who participate in the Teachers' Pension Scheme (TPS). We also considered how these costs might change in the future and the reasonable likelihood that a combination of adverse factors would lead to these costs increasing further in the future.

In February 2021 the Government provided the first indications of how some of these adverse factors will play out, in particular the impact of the McCloud judgement and the way in which the cost cap mechanism might be handled in future.

This note recaps on the potential headwinds and looks at how the latest Government announcement points the way towards the next phase of TPS change. It updates some of the comments made in our previous note, so for some readers it covers some familiar ground. We summarise the new developments below.

Background – the TPS 2016 valuation

Following completion of the 2016 valuation, the Government announced that employer costs would increase by 7.2%, from 16.4% of pay to 23.6%. This was a result of three factors:

- Changes in the assumptions used to assess the cost of pensions, which added 3.1%;
- The application of the 'Cost Cap Mechanism', which required there to be an improvement in the level of benefits being offered and added a further 2.3%; and
- A final adjustment of 0.8% to allow for the fact that time had passed between the date of the valuation (April 2016) and the date when the increases would come into effect (September 2019).

Actions to address the McCloud judgement[1]

The proposed solution for addressing the McCloud judgement is to offer all current members a 'best of both' solution for pension earned between 1 April 2015 and 31 March 2022. This means that, at the point of retirement, members will be able to choose either the old Final Salary approach or the new Career Average Revalued Earnings (CARE) benefit structure, whichever produces the most favourable outcome.

This 'Deferred Choice Underpin' (DCU) means that, inevitably, costs will be increased for employers. This is not just because TPS members who were moved automatically on to CARE accrual will now be able to choose the potentially more valuable Final Salary benefits, but there may be those who retained Final Salary benefits but who would actually benefit from the CARE benefit structure, and under the DCU approach will now be able to improve their benefits.

1 https://www.gov.uk/government/consultations/public-service-pension-schemes-consultation-changes-to-the-transitional-arrangements-to-the-2015-schemes/outcome/update-on-the-2016-and-2020-valuations

The Treasury announcement states that these additional costs will be taken into account when reviewing the impacts of the Cost Cap Mechanism. This will mitigate the impacts to some extent and means that the additional contributions in respect of the cost cap paid since 2019 will be put towards the cost of addressing McCloud, rather than increasing benefits for members.

The Cost Cap Mechanism is also undergoing a full review to determine how effective it has been in meeting its stated aims, and we may learn more about this in the Government's next report due in April.

The 2020 valuation

Given all the added complexity, it is no surprise that the 2020 valuation is going to take longer than usual to complete. Latest indications are that the impact of the valuation results and any changes in costs and benefits will come into effect from April 2024. This allows time for both a full review of the cost cap mechanism and for implementation of the McCloud judgement solution to be completed. It may well not be until that point that we actually know the impact of McCloud and the cost cap for both 2016 and 2020 valuations.

Given how the 2016 valuation results were implemented, it is reasonable to assume that if there is any requirement for costs to increase, then a delay in applying that cost increase will lead to an additional 'catch-up' cost for employers. The employer contribution rate following the 2016 valuation included a 0.8% loading for this reason, so it is likely that there will be a consistent component to the employer contribution rate that is ultimately required in 2024. This could be further increased if the implementation for schools is also delayed to the start of the academic year, as was the case in 2016.

Recap - assumptions and the SCAPE discount rate

Key assumptions

Pensions are long-term arrangements and if we want to know how much to pay today to provide a pension decades from now, we have to make a series of assumptions about how that pension might look when today's workforce comes to retire.

Given a particular pension scheme structure (in other words, the formula for calculating benefits), assumptions are needed to determine the costs:

- How long will that pension be paid for?
- How will the amount of pension change over the course of an individual's life both before and after retiring?
- How much money is needed today to provide that pension in the future?

This calculation can become hugely complex, with assumptions covering life expectancies, population demographics, the likelihood of members exercising any options they have and the rate of price inflation and salary growth all key. However, the assumption that converts all of this complexity into a final answer – "what is the cost today?" – is the discount rate.

Discounting

Discounting is simply the idea that if you need to pay a sum of money in the future, you don't need that much money today if you can earn a return on a smaller sum of money. For example, if you need to pay £100 in a year's time, but you're confident that you can earn 10% on your investments over the next year, then you only need to invest around £91 today: 10% growth on your fund of £91 will take you to just over £100 in a year's time.

SCAPE

TPS is not a 'funded' arrangement – the Government doesn't set aside assets to meet these long term pension obligations, but meets the payments each year as they fall due.

However, in order to work out how much schools are required to pay, the Government considers the amount of pension expected to be paid in each future year and calculates how much would need to be set aside now to pay for those benefits if TPS operated in the same way as a funded scheme. The calculation is entirely notional, but requires an assumption to be made about the rate of return – the discount rate – on the notional assets backing the scheme.

This discount rate is known as the SCAPE (Superannuation Contributions Adjusted for Past Experience) discount rate. It's set by the Government and, currently, by reference to the rate of expected long-term GDP growth. In 2018, this rate reduced from 2.8% to 2.4%[2], and this apparently modest change was sufficient to add 3.1% to the cost of TPS pensions.

It's worth noting this is the real rate of growth assumed, so represents growth in excess of price inflation.

Long term GDP growth

OBR forecasts

The Office for Budget Responsibility publishes regular reports on the expected near-term and medium-term rate of GDP growth. These were last reviewed in April 2019 and suggested real GDP growth of 1.6% p.a. in the near-term (2019 to 2023). From time to time, it also considers long-term GDP growth, but the most recent formal reporting on long-term growth was published in 2011[3].

Recent conditions

The last 18 months or so have seen a period of unprecedented economic disruption, with the prolonged Brexit negotiations giving way to the market shocks caused by the Covid-19 pandemic. GPD has taken a hit around the world, and the UK is no exception to this. There are numerous studies and speculative articles published, but a common theme is that clearly, GDP growth in the near-term will have taken a tremendous hit.

It remains to be seen what the longer-term impact of Covid-19 has on global and UK economic growth. However, even without that hammer blow, yields in the UK were at historically low levels with much uncertainty surrounding the future economic prosperity. However, one thing that most commentators would agree on is that expectations for long-term economic growth are unlikely to have improved since 2016.

What could this mean for TPS costs?

Sensitivity of results in 2016

According to the valuation carried out in 2016 by the Government Actuary[4], a reduction in the SCAPE discount rate of 0.25% would lead to an increase in the TPS employer contribution rate of 5.3%.

The report also states it's considered 'Likely' that the rate will change in time to affect the 2020 valuation, and that the impact of this *'may well be more than 2% of pay'.*

Weighing the odds

Given everything that has happened recently, the prospect of a further reduction in the discount rate, with the accompanying rise in TPS costs, must surely be a strong prospect. However, in a state-backed pension scheme, where rules can be revised and sometimes entirely scrapped at the behest of the Government of the day, nothing can be certain. The Government can, within reason, set the contribution rate at whatever level it chooses.

Where the employer contribution rate will end up is a matter of conjecture. We have seen estimates range from no change at all up to 35% or more. While the upper end of this range could seem like scaremongering, in reality, and according to the Government's own analysis, this could come about if the discount were to fall by little more than 0.5% (and that's without any allowance for McCloud).

It's in the interests of the Government to maximise revenue. Where contributions to public sector pension schemes come from private sector sources, as with Independent Schools, the payments represent net income to the Treasury (as opposed to the recycling of public money) and so the more incentive there is for the contribution rate to be as high as possible.

Set against this is the argument that it could be unwise for the Government to price Independent Schools out of the TPS market, however much actuarial sense it might make to increase costs by the sort of margins considered here. If the costs became unaffordable for the majority of schools, then the Treasury could lose a valuable source of private sector funds.

2 https://commonslibrary.parliament.uk/economy-business/work-incomes/public-service-pensions-less-for-more/
3 https://obr.uk/forecasts-in-depth/the-economy-forecast/real-gdp-growth/
4 https://www.teacherspensions.co.uk/-/media/documents/member/documents/news-items/teachers-pension-scheme-actuarial-valuation-2016.

Conclusion – what's changed?

The latest announcements are welcome as they start to remove some of the uncertainty surrounding the future of TPS:

- There is now at least an outline of how the outcome of the McCloud judgement will be implemented: TPS members will have the option to choose either the old scheme structure or the new one, whichever produces the better outcome, in respect of their service between 2015 and 2022. This 'best of both' option will inevitably result in an increase in costs, albeit potentially offset by some of the Cost Cap Mechanism contributions already allowed for, and this is expected to be most likely shouldered by the employers.
- The outcome of the 2020 valuation will be delayed and the impact of any changes in cost requirements arising from this will not be implemented until April 2024. It is reasonable to assume that, if the valuation requires a cost increase, then there will be a 'catch-up' increase due as part of this as was the case with the 2016 valuation.

All other factors remain up for discussion, but the arguments for cost increases remain at least as strong as they were last year: yields are low, life expectancies continue to rise (albeit more slowly) and the cost cap mechanism is to be retained in some form.

There is no consensus yet on the size of any potential increase in employer costs. Suggestions of the new employer rate being anything from no change at all (perhaps unlikely, but still possible) to 35% or more (arguably scaremongering) have been put forward, but an increase of even half the relative level seen in 2019 would see costs move to around 30%.

What else is happening in TPS?

We recently had the long awaited consultation response on Phased Withdrawal (or mixed economy) – see our briefing note and video library for more information.

This was intended to be an option for schools from Spring 2021. As we suggested may happen when the original timeframe was announced, the introduction of this option is now expected to be deferred.

Options for independent schools reviewing their participation in TPS

The September 2019 increases have resulted in many independent schools looking at alternative options to TPS (typically defined contribution in nature), whether it be as a replacement or additional choice.

There are many options for schools, including remaining in TPS, and we have supported schools consider these and develop the best possible solutions for their staff. Ultimately the best solutions will depend on the specific circumstances of a school and what teachers value the most, so it's important to take expert advice on what is available.

We are seeing an increasing number of schools looking to bring in flexible benefit reviews as part of a review of pension benefits and this is an exciting area for schools where there are a number of opportunities to support staff in the best possible way.

Please get in touch if you would like to discuss how we can help you consider your pension and benefit offerings to staff.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in with touch Tim Williams, Associate and FIA or Martin Willis, Principal and APFS via the following:

tim.williams@barnett-waddingham.co.uk 01242 538 557

martin.willis@barnett-waddingham.co.uk 01494 788 121

Or visit our website at: www.barnett-waddingham.co.uk/services/independent-schools/